VZCZCXRO3564
PP RUEHCN RUEHGH RUEHVC
DE RUEHBJ #4402/01 3370611
ZNR UUUUU ZZH
P 020611Z DEC 08
FM AMEMBASSY BEIJING
TO RUEHC/SECSTATE WASHDC PRIORITY 1169
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
INFO RUEHOO/CHINA POSTS COLLECTIVE
RHEHNSC/NSC WASHDC

UNCLAS SECTION 01 OF 05 BEIJING 004402

SIPDIS
SENSITIVE

STATE FOR EAP/CM AND E/YON
TREASURY FOR OASIA/DOHNER/WINSHIP
TREASURY ALSO FOR IMFP/SOBEL/MOGHTADER
NSC FOR LOI

E.O. 12958: N/A
TAGS: ECON EFIN CH
SUBJECT: CHINA/ECONOMY: DETERIORATION WAS SURPISING,
FISCAL SUPPORT FORTHCOMING; FED GOVERNOR KROSZNERQS
NOVEMBER 17-18 MEETINGS IN BEIJING

THIS CABLE IS SENSITIVE BUT UNCLASSIFIED. NOT FOR
INTERNET DISTRIBUTION.

¶1. (SBU) Summary. Chinese financial officials and foreign economists and bankers told Federal Reserve Board Governor Randall Kroszner that recent deterioration in ChinaQs real economy was much faster than they had expected. However, most were confident that the government would inject sufficient stimulus to ensure ChinaQs real GDP growth rate would not fall below 7-8 percent in 2009. Several contacts said they are concerned the rush to implement policies to cushion the cyclical downturn would undermine progress made in market-oriented reforms and rebalancing growth. While all interlocutors welcomed the recently announced fiscal stimulus, none offered consistent explanations of how much would come from the central government and how much represented additions to existing expenditures. Several contacts noted concerns that high level political support for fiscal stimulus would undermine efforts to increase the effectiveness of public infrastructure investment, giving the green light to local government boondoggles that had been held back due to concerns about overheating.

¶2. (SBU) Summary, continued. Several officials said that after fleshing out further details on the fiscal stimulus, the government will turn its attention to how to make banking operations and financial regulation and supervision less pro-cyclical, as banks are becoming increasingly market-oriented. Some officials noted that the government is considering explicit guarantees to encourage bank loans to targeted sectors, rather than relying on the moral suasion and implicit guarantees that occurred during previous cyclical downturns. Foreign banks continue to experience liquidity problems due to difficulties in borrowing from Chinese banks. While most interlocutors believed the U.S. had entered a prolonged recession, they were also concerned about inflationary pressures, in both the U.S. and abroad, that would be unleashed from the Federal ReserveQs large-scale liquidity injections. Although one foreign banker said Chinese banks have become more cautious about buying overseas assets, both CCB and CIC raised concerns about openness to Chinese investment in the U.S. financial sector. End Summary.

¶3. (SBU) During a November 15-18 visit to Beijing, Federal Reserve Governor Randall Kroszner participated in a Bank for International Settlements conference on Qthe role of banking and banking supervision in financial stability,Q hosted by the PeopleQs Bank of China (PBOC).

Kroszner held separate meetings with Central Leading Group (CLG) on Financial and Economic Affairs Vice Minister Liu He, China Banking Regulatory Commission (CBRC) Chairman Liu Mingkang, China Securities Regulatory Commission (CSRC) Chairman Shang Fulin, Bank of China (BOC) Vice Governor Zhu Min, China Construction Bank (CCB) CEO Guo Shuqing, China Investment Corporation (CIC) Chairman Lou Jiwei, Vice Chair Wu Xiaoling of the Financial and Economic Committee of the National PeopleQs Congress (NPC), Director Yu Yongding of the Institute of World Economics and Politics at the Chinese Academy of Social Sciences (CASS), and several foreign bankers and economists.

ChinaQs Slowing Economy

¶4. (SBU) All of Governor KrosznerQs interlocutors agreed that the direct impact of the global financial crisis on ChinaQs financial sector was limited, but it now is negatively affecting ChinaQs real economy, especially the export sectors. CIC Chairman Lou said the Qfinancial tsunamiQ had not hit China hard, but the global recession has a great impact on ChinaQs real economy. CASS Professor Yu and CLG Vice Minister Liu said the recent slowdown has caught many officials by surprise but growth would not fall below 8%, an assessment generally shared by the other contacts. Since October, industrial output has plummeted. (Comment: NDRC officials told FINATT that November economic data is likely to show growth decelerating as fast, or even faster, than October data). Liu believed there will be no growth in 2009 in some

sectors, such as heavy industry and textiles.

¶5. (SBU) BOC Vice Governor Zhu noted that power and transport figures were down on a year-on-year basis for the first time in this growth cycle. From the second to the third quarter, GDP grew only 4.6% on an annualized basis. Exports were slow and there is serious overcapacity in steel and manufacturing. The global financial crisis hit at a particularly bad time, because it impacted Christmas shipping and letters of credit at the time when exportersQ shipments usually peak. Zhu said 70,000 companies have closed in the Guangdong area. However, consumption is still strong and is underestimated in official data (Comment: Purchases of some motor vehicles and existing homes are included in fixed asset investment rather than consumption.). Zhu estimated that the final real GDP growth figure for 2008 would be 9%, and the economy would rebound quickly by the first or second quarter of next year, with 2009 growth reaching 7-8%.

¶6. (SBU) CLG VM Liu said BeijingQs top priority now is to promote growth. Inflation is no longer a concern as it will decline to 4% year-on-year for November, and next year there will be deflationary pressures due to excess capacity, weak demand and declining input prices. Unemployment is the biggest concern related to slowing growth, as the government is uncertain whether unemployed migrants will return home to the countryside or stay in the city and spark social instability. Liu said the government needs to Qbreak the market principle to keep the market viable.

Opportunities for Restructuring?

¶7. (SBU) Madame Wu of the NPC, who previously served as PBOC Deputy Governor, said China had Qtaken the long roadQ to reform, but the decline in the export growth rate due to the international financial crisis now was generating pressure to accelerate reform and structural adjustment. This, she said, was Qnot a bad development,

although the fall in export growth was not being compensated fast enough by domestic demand growth. One western economist agreed, noting that the current situation presents an opportunity for China to reform: for example, he said it would be a good time for China to allow its agricultural prices to adjust to meet international prices. Also, he believes the trade surplus will now need to come down more gradually, as there are millions of workers unable to find employment. He said some Chinese officials blame the United States for the global financial crisis, but China itself bears some responsibility due to its persistent trade surpluses and over-dependence on export-led growth. He also believes China should have begun to appreciate the RMB much earlier, so that there would have been less investment in the export and import-competing sectors, leaving China less vulnerable to a slowdown in external demand.

¶8. (SBU) Professor Yu of CASS said the GovernmentQs recently-announced stimulus plan had been prepared as a contingency earlier in the year. He expressed concern that focus on slowing growth and the stimulus would undermine support for continued structural adjustment. Exports and investment have been the two engines of growth, but are too volatile and have led to excess capacity; for example, China has 600 million tons of steel productive capacity but only 300 million tons of sustainable domestic demand. They have to decide whether to close the excess capacity or use fiscal policy to support it. Yu argued that China having a more flexible exchange rate is not in the United StatesQ interest, as foreign exchange intervention helps support demand for U.S. financial assets. Financial MinCouns Loevinger countered that since Chinese monetary authorities most likely hold more creditworthy assets than Chinese commercial investors, continued large scale foreign currency intervention exacerbates the retrenchment away from riskier financial assets.

Fiscal Stimulus: Enough?

¶9. (SBU) Liu said the RMB four trillion (USD 586 billion) stimulus package includes RMB 600 billion each year (to 2010) in central government money. The central spending will result in a deficit of 0.6% of GDP this year and 1.5% next year. Both Liu and CIC Chairman Lou agreed this is not enough, and the number likely will have to increase. Wu Xiaoling of the NPC said stimulus efforts should focus more on increasing consumption. One western banker observed that the fiscal stimulus package would not help the SMEs that have been one of ChinaQs growth engines.

¶10. (SBU) BOC Vice Chair Zhu said some observers are worried the stimulus package, by focusing on infrastructure investment, will exacerbate ChinaQs already capital-intensive growth, but most argue that China needs to Qsave the patient firstQ and then worry about structural problems. He estimated the stimulus would add 3% to GDP in the next two years. Much of the spending can come online within nine months. Targeted projects include railways, nuclear power plants, and ports, but there also will be RMB 1.5 trillion for health, rural, and education spending. He claimed a fiscal stimulus aimed at helping SOEs may not diminish ChinaQs productivity, as there is no evidence that the private sector is more profitable or efficient than SOEs. China would have no problem funding the stimulus, as inflation and corporate debt are low, household debt is just 19.6% of GDP, and government debt is around 20%.

¶11. (SBU) One western economist with close government

contacts said the stimulus is more consumption oriented than it appears, since much of the investment will go into areas such as construction of passenger rail lines that will stimulate consumption. He believes China will be able to implement the package fairly quickly, since most of the projects were already in the pipeline but on hold while the government was trying to cool the overheating economy. He also thought China would be open to imported components when implementing the stimulus, in order to access better technology.

ChinaQs Banks: Too Cautious?

¶12. (SBU) CBRC Chairman Liu downplayed concerns about banking sector health, claiming it would remain solid even in the face of a two-year slowdown (with real GDP growth falling to 8% and some deflation). According to BOC Vice Chair Zhu, the exposure of Chinese banks to the global financial crisis is limited. In the subsequent economic downturn, however, he predicted non-performing loan (NPL) levels will rise and profitability will fall, but not to unmanageable levels. He agreed with CBRCQs Liu that China has greatly improved its risk management and asset quality.

¶13. (SBU) CLG Vice Minister Liu agreed the banking system is Qsound,Q but banks now are unwilling to extend credit to SMEs. While the central government is currently focused on fleshing out details of the recently announced fiscal stimulus, its next task will be how to promote bank lending in a prudent manner. One option being considered is for the central government to provide explicit guarantees to banks and specific interest subsidies to borrowers for loans to firms in targeted sectors, such as SMEs. This would allow increasingly market-oriented banks to be compensated for taking credit risks. The government is also trying to encourage lending through collective bonds, where banks borrow on behalf of a group of debtors; Qeverything is under discussion,Q he said. Several foreign bankers and economists confirmed the central government is urging Chinese banks to lend, and the banks have extended more credit than is apparent. Banks also appear to be shifting loans to larger borrowers at the expense of job-creating SMEs. The same banker believes that as a result of increased lending, banks likely will face rising NPLs Q and the government will bail them out Q in the future.

¶14. (SBU) Liu acknowledged that foreign banks continue to

have liquidity problems due to the reluctance of Chinese banks to lend them RMB. One western banker reported that despite PBOCQs agreement to allow foreign banks to increase their borrowing from foreign affiliates, SAFE would not allow the foreign banks to bring in funds. CIC Chair Lou confirmed that banks were wary of extending credit, noting that despite government encouragement, banks would seek any excuse if they did not want to extend credit.

¶15. (SBU) CEO Guo of the CCB said his bank focuses on infrastructure and long-term loans in the highway, energy, railroad, and housing sectors, so the government stimulus program would be very beneficial. Bank profit growth is slowing, from 40% this year to an expected less than 10% next year, and many non-financial companies in China are losing money: 30% of steelmakers are posting losses and many exporters are closing, although CCB is not very exposed to that sector. Guo said CCB would begin to suffer asset quality problems (NPLs are currently 2.2%) if GDP growth dropped below eight percent.

U.S. Economy: Present and Future Worries

¶16. (SBU) While all of Governor KrosznerQs contacts were concerned that the U.S. has entered a prolonged Japan-like recession of several years, they also expressed concern about the global inflationary impact of the Federal ReserveQs large injections of liquidity. CSRC Chairman Shang said he believes the U.S. downturn would last a year or so, but also noted many Chinese experts are forecasting a 2-3 year recession. CSRC Director General Tong Daochi was concerned that recent moves by the Federal Reserve to lower interest rates and increase liquidity would only lead to more asset bubbles. The NPCQs Wu was concerned that the Federal ReserveQs excessively loose monetary bias was keeping the US dollar too low, with excess liquidity flowing to China, maintaining upward pressure on the RMB and downward pressure on ChinaQs interest rates, and promoting excessive investment.

Investment in the U.S.

¶17. (SBU) Although one foreign banker said Chinese banks have become more cautious about buying overseas assets in light of domestic criticism of high-profile losses to date, both CCB and CIC raised questions about possible investments in the U.S. CCB CEO Guo said his bank currently is considering overseas investments. He said ChinaQs enormous reserves will decline in value in the long-term if they are kept in debt, so they should be diversified into equity. More specifically, Guo asked about U.S. banking regulations limiting Chinese investment of 10% or more in a U.S. bank, and also CFIUS regulations triggering reviews if foreign investments exceed 10% of equity; the expected U.S. reaction to investing Chinese foreign reserves in large U.S. companies; and, the reaction to Chinese investment in non-bank and high-tech companies. CCB also inquired about the status of its pending application to open a U.S. branch, and asked for approval to increase its equity stake in a U.S. bank from 5 to 10%.

¶18. (SBU) Asked about his corporationQs interest in investment in U.S. banks, Chairman Lou said CIC had held QintenseQ negotiations with Morgan Stanley. CIC eventually decided not to proceed Qfor many reasons,Q the most significant of which was its failure to receive from the U.S. Federal Reserve a written exemption from U.S. regulations and investment Qbarriers,Q including the Bank Holding Company Act. Lou lamented that CICQs inability to increase its stake in Morgan Stanley had become viewed as a symbol of the United StatesQ lack of openness to Chinese investment.

Comment

¶19. (SBU) Officials appeared caught off guard by OctoberQs deceleration in growth and hinted that the

economy may stall or even decline on a sequential basis in the fourth quarter. Interlocutors stressed that the government had set a floor of eight percent real GDP growth. However, it was apparent that reformers are also concerned that political issues related to slowing growth will strengthen the hand of vested interests, which want to slow or roll back efforts to continue market-oriented reforms and economic rebalancing. In addition, the lack of consistent and coherent explanations from senior economic officials of the size and content of the fiscal stimulus supports the view that the RMB four trillion headline number was rushed out in advance of the G-20 summit and the release of October economic data, with little consensus about its underlying content. Few interlocutors saw the conflict in their concerns about a

protracted and deep U.S. recession and future inflationary risks. And, few agreed that the best way to address concerns about U.S. monetary policy is to pursue greater monetary policy independence through a more flexible exchange rate.

¶20. (SBU) Governor Kroszner did not have an opportunity to review this cable.

RANDT